# DOW THEORY LETTERS INC.

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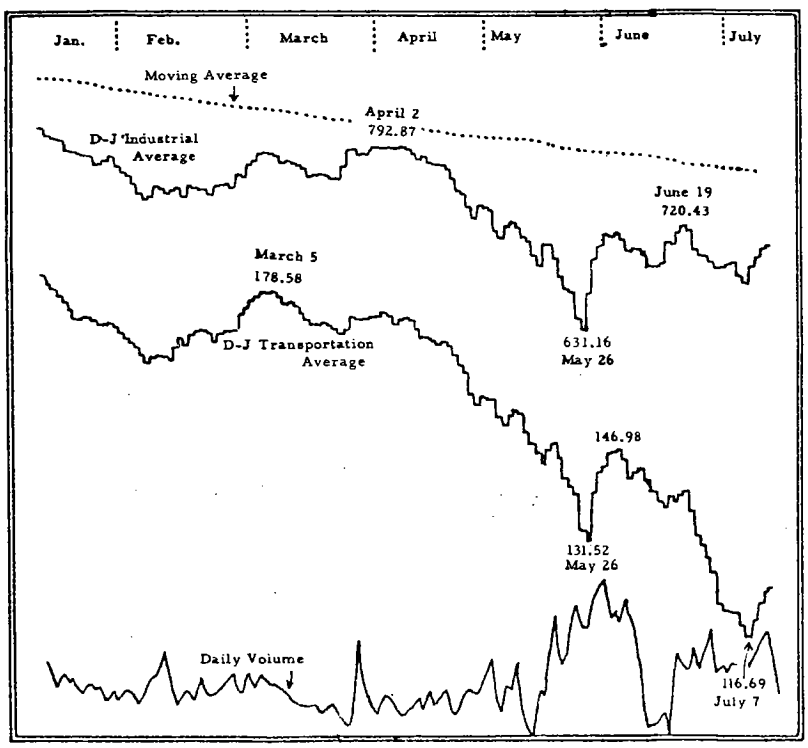
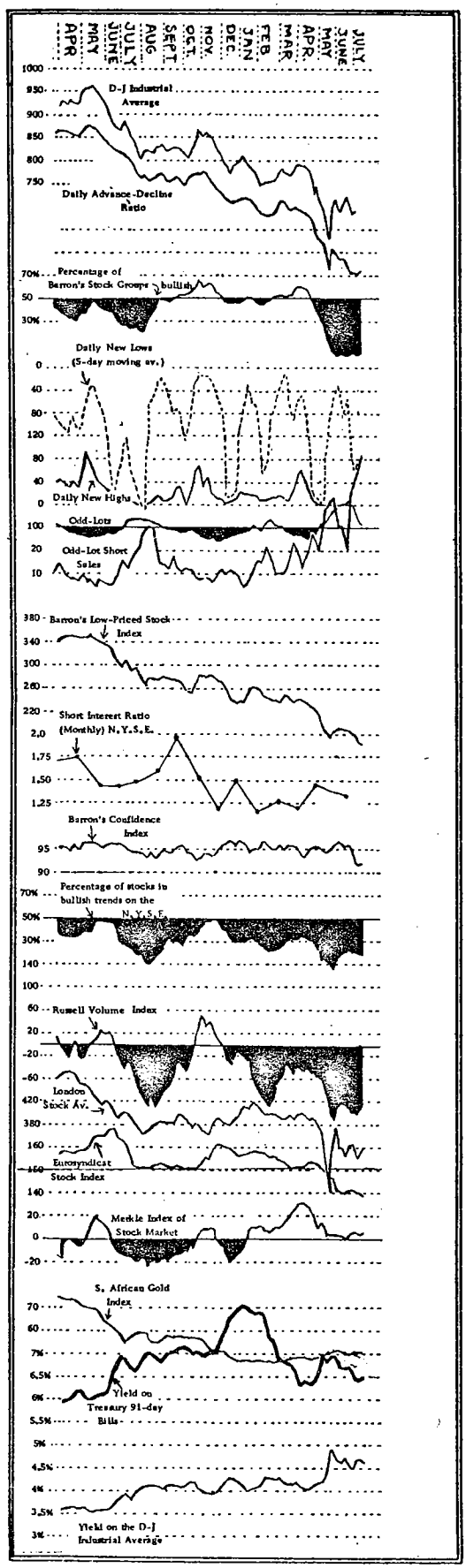
THE MARKET: On December 3, 1968, the D-J Industrial Average stood at a peak of 985.21, 10 points below its 1966 record high of 995.15. On February 7, 1969, the D-J Transportation Average stood at 279.88, its all-time high. In the approximate year and a half since then, the Averages sustained their worst losses since the crushing bear market of 1937.

By May 26, 1970, the Industrials had dropped to a bear market low of 631.16, a loss of 36% from the late-1968 high. A few months later, on July 7, the Transportation Average thudded to a low of 116.69, a loss of 58% from its early 1969 peak. Thus both of the Averages have suffered violent and severe declines during the past year and a half, and if the same rate of descent continued, Industrials would be 400 by the end of 1971 and Transportation would be 50.

Is that possible? Is it possible that the 1969-1970 rate of descent could extend through the rest of 1970 and into 1971? Frankly, I haven't the vaguest idea, but it certainly would not surprise me. The one thing I do know, however, is that the market never goes up or down in a manner that suits the majority. History shows that bull markets go up in such a way as to bring in the public near the top third of the rise — and bear markets go down in a way which is calculated to separate the public from its shares during the last third of the decline.

Now in order to do this, a bull market must produce fear during its first two-thirds. And a bear market must hold the public's confidence during its first two-thirds. It is a fact that nothing in a bear market keeps the public happier than occasional and "surprising" rallies. Usually the greater the decline and





D-J Industrial Average
Daily Advance-Decline Ratio
Percentage of Barron's Stock Groups bullish
Daily New Lows (5-day moving av.)
Daily New Highs
Odd-Lots
Odd-Lot Short Sales
Barron's Low-Priced Stock Index
Short Interest Ratio (Monthly) N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on the N.Y.S.E.
Russell Volume Index
London Stock Av.
Eurosyndicat Stock Index
Merkle Index of Stock Market
S. African Gold Index
Yield on Treasury 91-day Bills
Yield on the D-J Industrial Average

the more frightened the public, the greater the ensuing rally during a bear market. Since the May 26 Industrial low of 631.16, we have witnessed the remarkable phenomenon of new lows in the Transportation, Utility and 40-Bond Averages, vast new lows in the advance-decline index and the low-priced stock index, but a refusal by the Industrials to penetrate their June 26 bottom.

his performance has served three purposes. It has allowed hundreds of stocks to smash to new lows and others to be distributed without unduly upsetting the market, it has kept the public hoping ("Hey, the Dow is still well off its May low"), and it has set up the technical conditions for a possible continuation of the secondary uptrend which began on May 26. As you can see on the page 1 chart, the Averages are now wildly "out of gear". In order to produce a valid signal for a continuation of the secondary up-trend, Industrials would have to better their June 19 recovery peak of 720.43 (not too difficult a task), and Transportation would have to better its June 3 recovery peak of 146.98 (a very difficult feat from the current level). Nevertheless, the present position of the Averages allows for a good deal of "bouncing around" or even a strong rally from here without reversing the secondary price structure to the bullish side.

It is entirely possible that the bear could now hold off until late summer or fall, and thereby bring in a new crop of hopefuls. But ultimately, the forces of the bear will shatter the May-July lows on the Averages, and the majority of stocks will smash into new low ground for the entire bear market.

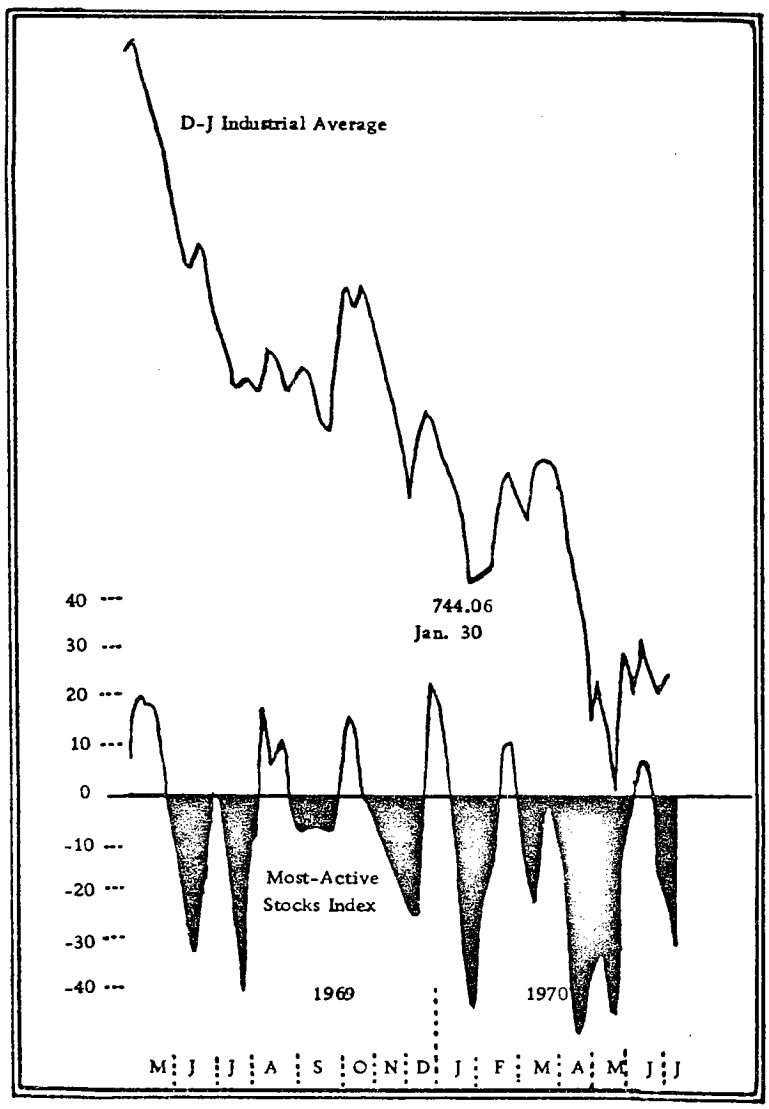
I cautioned in the last Letter against the kind of thinking (so prevalent among the soothsayers of today) which says that the market "will do such and such within this or that length of time". Forget it; the market will tell its story in its own good time, and today's in-and-out investment advisor will be next month's biggest fool. Suffice it to say that the primary bear market continues, and that as long as it does continue the most important thing to remember is that the market will eventually plunge to new, costly lows. Therefore, for Dow Theorists the answer is patience on the rallies and humility on the declines. The area we are waiting for is the bottom, and there has been no signs of that since the bear market began.

WHERE THE ACTION IS: The "20-Most Active Stocks" are listed weekly in Barron's. Weekly, this list tends to comprise about 15% of all N.Y.S.E. action, and experience has shown that the direction of the majority of the most active stocks usually points the way (or leads the ay) for the rest of the market.

The Most Active Index is simply the plurality of issues which advanced or declined each week, tabulated in the form of a three-week moving average. In other words, if 15 of the most active stocks advanced during the week and 5 declined, the weekly figure would be plus 10. This study was last reviewed in Letter 459, and I again urge subscribers to keep a file of back Letters for reference.

The year 1970, so far, has produced one of the worst records in the history of the Most Active Index, certainly much worse than 1969 (which produced a dismal record on its own). Of the 28 weeks which have elapsed so far in 1970, the Most Active Index has managed to produce only 6 weeks on the plus side.

The accompanying chart documents this statement. After a peak of plus 21 during the week ending January 2, the Index went heavily negative, then rose to a plus 10 during the week ending March 6. The index then plunged again to a drastic low of minus 50 during the week ending April 24. This was followed by a plus 7 on the week ending June 12 (the lowest plus reading of the year). By last week the Index had sunk to a minus 31.




onclusion: The Most-Active stocks have been decidedly on the downside during most of 1970, and this situation

Here are bonds yielding 10% to 25%. These bonds are yielding these whopping amounts because there are serious doubts as to whether these companies will survive in their present form. Yet, note the price on the common shares. These prices are a testament to the still continuing "cult of equity". Think about it; it just does not make sense. Would you pay the the prices mentioned for the common of these companies when their bonds are yielding 10 to 25%? For instance, with Pan American's bonds (convertible at that) yielding almost 16% (at which yield you would get your original money back in six years, assuming the company stays in business), who in the world would want to pay the current 8 1/2 for the common? If the company get back into good shape the bonds would be likely to rise to 60 long before the common even gets in shape to pay a dividend. In other words, at current levels, if the convertible bonds of Pan American are only worth 36, I wouldn't want to own a share of the common at anything over a few dollars.

The common shares of the companies mentioned are selling at their current levels only because of the built-in, fantastic faith in common stocks. Nothing else can explain why the commons are still selling on hopes and the bonds are selling discounting something just this side of bankruptcy.

Now, the investment fraternity is beginning to wake up to this stock-bond relationship, and my bet is that the trend is going to be towards what was known as "normal" in the 1930's, '40's and '50's. Increasing investment status is going to be accorded to bonds and increasing realism is going to hit common stocks. The go-go boys and the high-flyer buyers are going back to selling shoes, and Wall Street is going to start paying attention to values again. That is the way I see the trend going as the bear market continues.

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Question: Would you venture an opinion regarding the stock market if peace suddenly came to Southeast Asia:
Answer: There could be a temporary secondary upward correction, but as I have said repeatedly, the primary trend ends with only one condition — exhaustion. Once a primary bull market or bear market is in force, the market will move in the direction of the primary trend until the worst (in a bear market) or the best (in a bull market) is fully discounted in the price structure. There seems to be no way in which I can get this concept over to all my subscribers.

President Nixon has already announced a scaling down and ultimate cessation of U.S. activities in Asia. The market knows the end must eventually come, and that fact is already built into, and fully discounted by, the Averages. The only surprise might be a "new" and bigger war.

Even if the Government could get lucky enough to have an expanding economy between now and election time, it would only be a temporary solution. Mr. Donald Storey, in the current issue of the Bank Credit Analysts, put the whole thing quite beautifully: "Should the Fed. be successful in preventing a substantial economic correction now, by definition none of the basic problems would be solved, such as deficient liquidity, inflation, high interest rates, balance of payments deficits and steady attrition of corporate profit margins. At best, only some time would be purchased at the expense of even greater distortions and problems later. Liquidity can really only be restored by the acquisition of real resources; it cannot be done by resorting to the printing presses."

NOTE: From reports, I hear President Nixon is not even looking at Vietnam these days. His attention is rivited on the Mid-East. Here the overriding question, aside from the possibility of a full scale Arab-Israeli war, is whether there will be a hair-raising Russian-U.S. confrontation. Israel must have air superiority if it hopes to survive, and that means planes from the U.S. The Arabs are fighting a war of attrition, and with the actual combat help of 3 to 5 thousand Russians, the war takes on a new and ominous complexion. I believe that Russia will test the U.S. nerve before the end of the year. And that may mean a U.S. ultimatum to Russia. As one General (who knows the area thoroughly) told me yesterday, "The Arabs are crazy and the Israeli's will fight to the last man. The U.S. will not let Israel go under, and it cannot afford to take an implacable stand against the Arabs." This could be President Nixon's gravest problem and decision coming up. I don't even like to think of the implications.

Question: Will you be recommending stocks to buy when you believe the time is right?
Answer: This is the most frequent question received here, and I think the question itself is significant. Even my own subscribers are itching to spend some of that cash that they took out of the market. When they stop asking that question, we'll probably be near the bear market bottom, and conditions will be so bad that subscribers will be asking me how I have the gaul to suggest that a major buying area is nearing.

But the answer is, "Yes," I do very definitely intend to recommend stocks when I feel the time is right. I expect to be in there buying myself at that time.

Question: What is happening now that the Fed has lifted the 6.25% ceiling on Certificates of Deposit at the banks?
Answer: According to Aubrey Lanston & Co.'s (major bond dealers) latest report, "Government dealers have seen (Treasury) bill buyers in the last week or so who had all but forgotten what a Treasury bill looked like. Obviously, many investors felt uncomfortable about the size of their commercial paper holding and as contracts matured some of them were shifting out of paper to Treasury bills and other instruments."

What has been happening is one of the most dramatic stories of the past few years. With the Penn Central debacle, the whole $39 billion dollar commercial paper market has come under suspicion. Corporations who have been kept alive on a sea of commercial paper are finding that their paper is unsalable at any price. Former buyers of their paper are now loaning their money to the banks (C/D's) or the Government (Treasury bills). Safety and quality are the word. (As a footnote, I might add that Barron's Confidence Index last week dorpped 3.1 points, one of the largest drops on record, and this right after my article on bond yield spreads in Letter 466). In bonds, commercial paper, C/D's, debts of all kinds, quality and safety are becoming king.

Now here is a very important point. Commercial paper has had a large part in financing the consumer credit market. With the quality of many corporations' paper being questioned, the commercial paper market is bound to contract. This will mean that it will be difficult for those corporations to finance sales, and sales will subsequently contract. As sales contract, profits (particularly in highly leverages, illiquid corporations) will tumble. This in turn will cut Government corporation tax receipts and the Government deficit should climb to dangerous levels. The end result will be Uncle Sam coming into the bill, note and bond market with whopping financing as corporations in weak financial condition are forced against the wall.

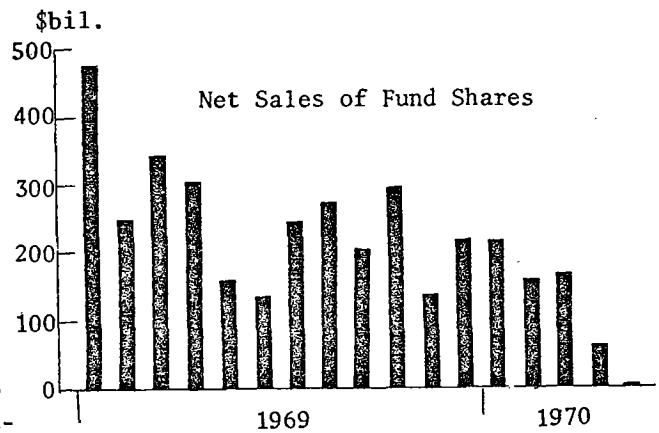
Question: Now that mutual funds have taken such a beating, don't you think this is a good time to buy a few fund shares?
Answer: No, I don't. I am including the latest compilations by Arthur Lipper & Co. Note that the average of all funds are off 25.3% from a year ago, while the S & P comprehensive 500 stock average is off 19.5% and the Dow Industrials are off 13.4%. I read this in a rather unorthodox way. The better the quality on this list, the less the loss, the worse the quality, the worse the loss. The list starts with the high quality Dow Average off 13.4%, moves to the lower quality of the comprehensive 500 Stock Average and ends with the average performance of 298 growth funds — off 30.8%.

## FUND INDEXES

Following are Arthur Lipper & Co. mutual fund indexes, including reinvestment of all distributions, for the week:

| No. & Type of Fund | | Per Cent Change Year to July 9 | Week of July 9 |
|---|---|---|---|
| 461 All Funds | | —25.38 | +0.71 |
| 298 Growth | | —30.85 | +0.61 |
| 91 Growth & Income | | —18.13 | +0.94 |
| 24 Balanced | | —14.25 | +0.84 |
| 43 Income | | — 9.44 | +0.85 |
| 5 Bank & Insurance | | —21.81 | +0.41 |
| * * * | | | |
| Dow Industrial | 692.77 | —13.44 | +0.53 |
| S & P 500 | 74.06 | —19.55 | +1.56 |
| S & P 425 | 81.04 | —20.15 | +1.17 |
| N.Y.S.E. Comp. | 40.26 | —21.87 | +1.56 |
| Amex Index | 19.89 | —24.29 | —0.30 |

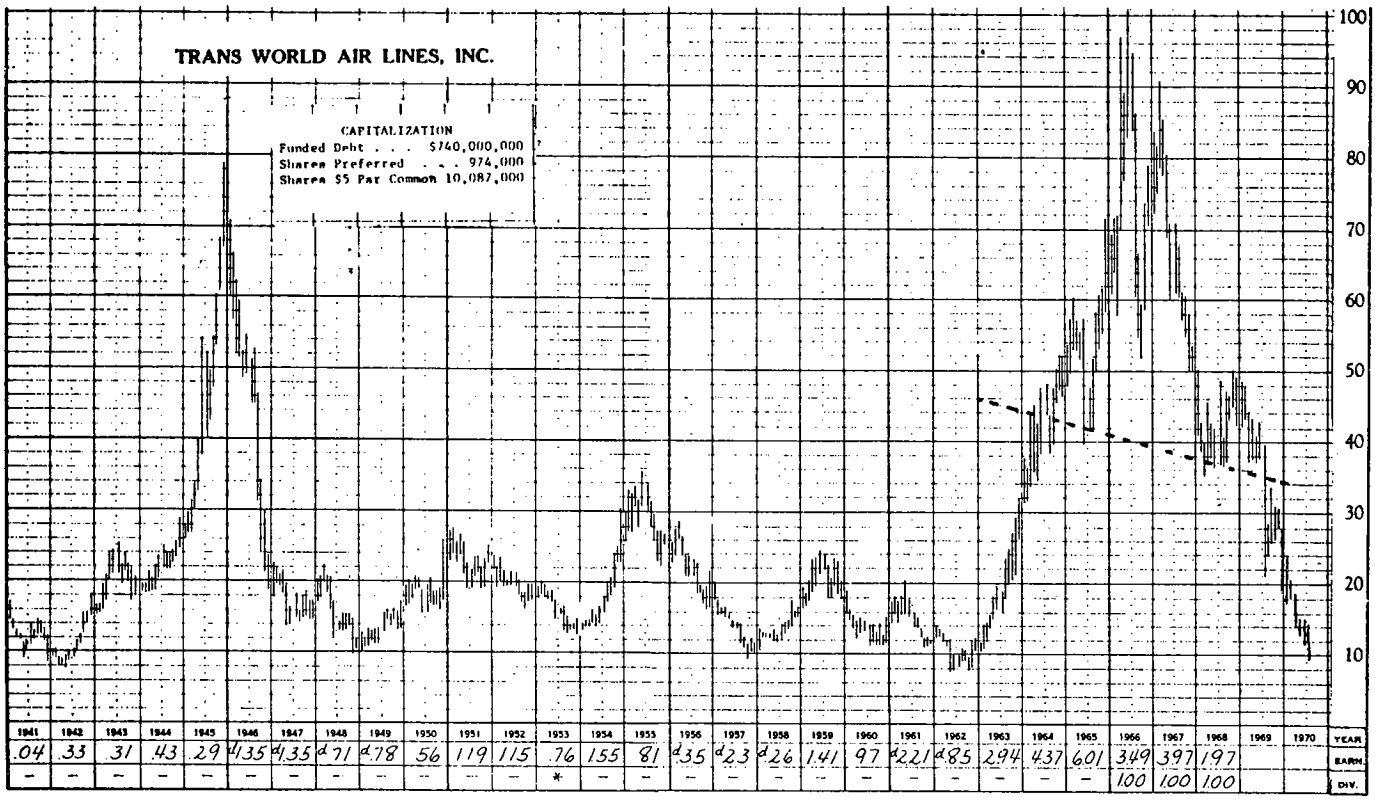
Now what is happening on Wall Street among other things is a decline in confidence. No longer can funds be sold on the basis of the old 25-year growth chart. The public is slowly turning sceptical, and we can see this on the chart published by the Holt Advisory Service. Against 1969's net sales (i.e., purchases minus redemptions) of $303 million in May 1969, May 1970 produced net sales of $3.2 million. This obviously means that many funds are undergoing net losses of cash (more sales than purchases) and they are being forced to sell stocks in this market to raise cash for redemptions. As the bear market mood becomes more pronounced, I expect this process to expand. If that does happen, then the funds will exert a steady pressure on this market in that they will be forced to dump stock to raise cash. Furthermore, the spector of increases in redemptions is causing many funds to boost their cash position, not for the purpose of buying stocks but to have cash ready for possible redemptions.




Aside from all this, I do not recommend purchase of fund shares or any other type of share while the bear market is on. The figures show that so far, the funds have been worse than the market, and obviously if I do not like the market I like the funds even less.

Question: What's happening to the transportation Average. Is it "going out of business."
Answer: No, but a number of transportation companies are in severe trouble. For a decade this writer received letters from subscribers to the effect that the rails were a dying industry and that only the inclusion of airlines and trucks would make that Average a valid indicator of transportation. Well, we've got the new Average, and it collapsing anyway. A number of airlines look on shaky grounds to me including Trans World, Seaboard World, Western, World Airways. In many cases, it's a question of their debt eating up their capital and profits. As for rails, such outfits as Rock Island, Northwestern, Milwaukee (which is not paying its fixed charges), Reading and Jersey Central are all finding the road rather rocky.

As for the Government nationalizing the rails, forget it. If they did so they would have to pay stockholders the book value of the stocks. Penn Central's book value happens to be over $120 per share, for example.

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TOCKS: The long-term monthly chart of TWA is most interesting. In the last thirty years, TWA has produced two major upward surges, one during 1945-46 and one during 1964-66. The 1946 affair, which took TWA to 79, was followed by a crushing bear market collapse to the 1948 low of 9 7/8. The airline languished for the next 14 years.

A new upward surge began from the 1962 bottom. By 1966 TWA had touched an all-time high of 101. From there, the stock broke down badly, hitting a 1969 low of 21. As seen on the chart, I have drawn in the "neckline" (dashed line) of what appears to be a titanic head-and-shoulders distribution pattern. In July, 1969, the neckline or support level was smashed, and TWA plunged to its 1970 low of 9 3/4. This was approximately the major support level which held the stock in 1942, 1948 and 1962.

I would say that if TWA broke below 8 in the period ahead, it would be a very ominous indication. The possible meaning of such a break is obvious enough, in view of what occurred to Penn Central.

A glance at the balance sheet of TWA is instructive. From 1965 to 1969, TWA's long-term debt rose from $276 million to $757 million. Its book value rose from $26.50 to only $29.94 during the same period. Total operating revenue rose from $672 million in 1965 to $1.098 billion in 1969. During that time net income dropped from $50 million to 1969's $19.8 million. For a variety of reasons, TWA's expenses have risen sharply while net income has dropped. In first quarter 1970, TWA produced a loss of $39.7 million vs. a loss of $14.9 million in first quarter 1969. It is obvious that TWA must control expenses or be pushed to the edge. This is true even while passenger traffic is good. During a primary bear market, however, there is nothing that says that passenger traffic cannot fall off sharply.

LATE NOTES: Barron's Low Priced Stock Index hit a new bear market low of 170.4 on the week ending July 10 (see Letter 454). This is normal bear market action, by which I mean that once having topped out, the L-P stock Index generally sinks steadily lower to a final bear market bottom (which in Letter 454, I opined would be under the 1958 low of 68 for the Barron's Index).

Estimated first quarter earnings (see Barron's) for first quarter 1970 is $11.53, down 19% from first quarter 1969's $14.26. Few seem aware of the magnitude of the drop.

lmost all the services are talking about the heavy odd-lot shorting and the probability of May 26 having been an important bottom. They may be correct, but I get the feeling that everybody's looking at the same thing. When everybody thinks the same, I distrust the conclusion. I have no strong convictions on the subject, but I find myself distrusting the thesis of a big summer rally from here.